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TAGS: EFIN ECON ELAB ALOW AR
SUBJECT: BCRA Meets its Monetary Target, but Is Not Fighting Inflation

¶1. (U) Sensitive but unclassified. Not for internet distribution.

Summary

¶2. (SBU) The average M2 level during the first quarter was close to the lower end of the Central Bank's (BCRA's) Monetary Program target. Still, M2 increased 26 percent y-o-y, and would have increased 28 percent but for a last-minute transfer of social security funds to a time deposit in late March. The BCRA introduced two measures that appeared to signal a tightening bias in monetary policy, but real interest rates remain negative and fell even further in the first quarter, to -6.2 percent on time deposits. The BCRA's priorities continue to be accumulating reserves and avoiding peso appreciation, not attacking inflation. So far, the BCRA has been able to sterilize its dollar purchases by issuing Lebacs and Nobacs and encouraging discount window repayments, while avoiding sharp interest rate increases. However, in the future the BCRA may have to allow interest rates to increase further with the downside of eroding the BCRA's quasi-fiscal surplus. The BCRA should be able to meet its M2 target this year, but it will have to ignore M3 growth, which may better reflect recent growth in the money supply. End Summary.

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BCRA Meets Monetary Target for the 11th Consecutive Quarter
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¶3. (U) The Central Bank (BCRA) announced that it fulfilled its monetary target for the first quarter of ¶2006. According to BCRA data, the average M2 (cash plus public and private sector current and saving accounts) level during the quarter was ARP 106.2 billion, close to the lower end of its Monetary

Program target of ARP 104.4 billion, and well below the upper limit of ARP 110.9 billion. During the quarter, M2 increased ARP 2.3 billion (26.5 percent y-o-y) to ARP 106.2 billion. M2 increased 2.2 percent q-o-q due to an ARP 1.4 billion increase in public and private sector sight accounts and an ARP 900 million increase in cash in circulation.

¶4. (U) This was the eleventh consecutive quarter in which the BCRA has met its target. The BCRA shifted to an M2 target instead of the monetary base because M2 better reflects monetary conditions due to the increase in the money multiplier. The 2006 monetary program envisions a deceleration in M2 growth, which is expected to increase 21.2 percent in 2006, well below the 36 percent, 33 percent and 25 percent increases seen in 2003, 2004 and 2005, respectively.

¶5. (U) Economic consultant Miguel Angel Broda recently noted that meeting an M2 target is not exempt from "creative accounting" by, e.g., asking a public institution to transfer its transactional deposits (funds held in savings or checking accounts) to time deposits. Broda points out that the social security agency transferred ARP 1.5 billion from its sight accounts to a time deposit at the end of March. Without that transfer, M2 would have increased 28 percent y-o-y in the first quarter.

Monetary Base

¶6. (U) The monetary base increased ARP 2.6 billion in Q1 to ARP 58.5 billion, mainly due to the BCRA's emission of ARP 7.9 billion to purchase dollars to rebuild its reserves and avoid peso appreciation, as well as ARP 2.8 billion in repo transactions. This increase was partially sterilized by ARP 5.0 billion in banks' repayments of their discount window lending to the BCRA, an ARP 1.7 billion GOA repayment to the BCRA for short-term financing, ARP 994 million in net issuance of Lebacs and Nobacs, and ARP 300 million of other factors. (Note: As of the end of March, three banks -- out of 24 at the beginning of the 2001 financial crisis-- still owed the BCRA a total of ARP 6.2 billion for discount window borrowing. End Note.)

BCRA Reserves

¶7. (U) BCRA reserves decreased 23 percent in the first quarter, to USD 21.5 billion, mainly due to the GOA's full prepayment of its USD 9.5 billion IMF debt on January 2. However, the BCRA's steady intervention in the foreign exchange market during the remainder of the quarter allowed the BCRA to add USD 2.3 billion to its reserves, recovering 24 percent of the IMF payout. The BCRA's monetary program envisions a complete recovery of reserves this year back to USD 28.0 billion, their level prior to the IMF payment.

Time Deposits and Loans

¶8. (U) Average total time deposits increased slightly during the first quarter, from ARP 49.9 billion to ARP 50.7 billion, due to an increase in private sector deposits that more than offset a fall in public sector deposits. Loans to the private sector increased 9 percent from ARP 43.7 billion to ARP 47.5 billion (average of the quarter). At the end of March, loans to the private sector totaled ARP 48.8 billion with consumer loans, mortgages and current account advances representing 30 percent, 18 percent and 40 percent,

respectively.

Interest Rates

¶9. (U) The BCRA increased the 7-day active repo rate (the rate at which the BCRA offers financing and adds liquidity to the system) by one percentage point in the first quarter, to 7 percent. The BCRA maintained passive repo rates (the rates at which the BCRA borrows funds and absorbs liquidity) unchanged at 4.5 percent for a 1-day repo and at 5 percent for a 7-day repo. [Note: repo agreements -- repurchase transactions -- involve temporary loans of securities in return for short-term financing. End Note.]

¶10. (U) In December 2005, the BCRA ended its policy of shortening Lebac maturities to avoid interest rate increases. Since the beginning of the year, the BCRA shifted to issuing longer-term Nobacs, which carry a variable rate of Badlar (rate for deposits of more than ARP 1 million) plus a spread (determined at the BCRA auction). Badlar rates increased from an average of 6.80 percent in the last quarter of 2005 to an average of 8.20 percent in first quarter of 2006. Currently the BCRA is paying interest rates of 12 percent on the 2-year Nobac, roughly equal to expected inflation.

¶11. (U) Lebac interest rates remained almost unchanged at the short end of the curve (less than three months) at 6.7 percent, 6.8 percent, and 7.2 percent for the 1-month, 2-month and 3-month instruments, respectively. However, the interest rate on the 6-month Lebac increased by 80 basis points to 8.3 percent at the end of the first quarter.

¶12. (U) While Lebac rates remained almost unchanged during the first quarter, it is important to note that their relative participation in the stock of BCRA paper outstanding decreased sharply during the first quarter, from 74 percent to 42 percent at the end of March, with a stock outstanding of ARP 11.8 billion. At the same time, Nobacs increased their participation from 26 percent to 58 percent, with a stock outstanding of ARP 16.3 billion. Nobacs increased their participation in tandem with the increase in Badlar rates. Investors shifted to Nobacs because they offer better yields and better protection against inflation than Lebacs.

¶13. (U) Market rates for time deposits and the call interest rate -- the inter-banking lending rate -- both increased in the first quarter. The average rate for time deposits jumped 130 basis points from 4.80 percent to 6.10 percent, while the call rate increased 90 basis points from 6.00 percent to 6.90 percent.

BCRA Sends Mixed Messages on Monetary Policy

¶14. (U) The BCRA introduced two measures in the first quarter that appear to signal a tightening bias in monetary policy. First, the BCRA increased bank liquidity requirements for sight accounts (current and savings accounts) by 2 percentage points to 17 percent. Second, it eliminated the 2.55 percent annual rate that the BCRA paid banks for their minimum reserves. These measures should stimulate a shift from M2 and into time deposits and may force an increase in interest rates. However, by themselves, these measures do not indicate a turning point in BCRA policy.

¶15. (SBU) Monetary data indicates that the BCRA's

priorities are accumulating reserves and avoiding the peso appreciation. So far, the BCRA has been able to sterilize its dollar purchases by issuing Lebacs and Nobacs without raising interest rates sharply, aided by banks repaying their discount lending to the BCRA. That will not be possible indefinitely, and at some point, the BCRA may have to allow interest rates to reach positive levels. That will reduce the BCRA's quasi-fiscal surplus. Discount loans are the BCRA's best-performing asset, and the rise in repayments reduces the BCRA's surplus even further.

¶16. (U) In a recent interview, BCRA President Martin Redrado said that the BCRA may sell its holdings of Boden 2011 bonds to supplement the BCRA's absorption capabilities. This appears to confirm the concerns of some analysts that the BCRA will have problems containing money supply growth while rebuilding reserves, although Redrado downplayed those concerns. [Note: The Boden 2011 is a peso-denominated bond adjusted by CER (CPI-linked index) with a 3.5 percent coupon. The BCRA holds ARP 6 billion worth of Boden 2011 and is the only owner of this bond, which it received from the GOA in compensation for the BCRA's purchase of provincial quasi-monies in 2003. End Note.]

¶17. (SBU) At first glance these measures appear to indicate a turning point in BCRA monetary policy towards a tightening. However, the current level of real interest rates suggests a need for a further tightening. For example, real interest rates (based on expected inflation as measured by the BCRA consensus survey in March each year) were lower in the first quarter, y-o-y. Real interest rates on time deposits averaged -6.2 percent at the end of the first quarter, compared to -5.7 percent in the first quarter of 2005. This is consistent with the Kirchner

Administration's goal of expanding domestic demand, as lower interest rates generally, and negative interest rates in particular, give people an incentive to increase consumption and decrease savings. But this is not consistent with a monetary tightening to combat inflation.

¶18. (SBU) The BCRA's management of the monetary base is not an objective in itself but helps the BCRA meet its M2 target, since M2 equals the monetary base times the money multiplier. The BCRA measure increasing bank liquidity requirements decreased the money multiplier, because it requires a higher proportion of reserves for each peso in the financial system, reducing secondary money creation. The increase in reserve requirements for sight accounts should generate an increase in time deposits (and thus reduce M2) but this shift may in the end produce an increase in the money multiplier for M3 (a wider monetary aggregate equal to M2 plus private sector time deposits) because reserve requirements for sight accounts are larger than for time deposits. Thus, the BCRA will fulfill its M2 monetary target this year, but it will have to ignore the likely growth in M3, which may be the most appropriate variable as it includes private sector time deposits and better reflects the growth of money supply.